

# ANALYSIS OF AMENDED BILL

## Franchise Tax Board

Author: Campbell Analyst: Jeff Garnier Bill Number: AB 2590  
Related Bills: See Legislative History Telephone: 845-5322 Amended Date: 4/13, 26 & 5/6 2004  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Apportionment of Business Income

### SUMMARY

This bill would make changes to the way California income is calculated for certain corporations that earn income from multiple states or other countries by:

- changing the standard apportionment formula used to determine the amount of business income taxable by California to a three-factor apportionment formula with single weighted payroll and property factors and a sextuple weighted sales factor for taxable years beginning in 2005 and a single-factor apportionment formula based on sales for taxable years beginning on or after January 1, 2006,
- requiring certain corporations to use the current three-factor formula based on property, payroll, and double-weighted sales, and
- allowing certain businesses to choose either the current three-factor formula based on property, payroll, and single-weighted sales, or use one of the new formulas.

### SUMMARY OF AMENDMENTS

The bill as introduced on February 20, 2004, was a spot bill.

The April 13, 2004, amendments made the single-factor apportionment formula based solely on sales and other changes discussed in this analysis.

The April 26, 2004, amendments inserted the three-factor apportionment formula with single-weighted payroll and property factors and a sextuple-weighted sales factor for taxable years for 2005 only and made several miscellaneous amendments.

The May 6, 2004, amendments made technical changes relating to the operative dates of the provisions.

This is the department's first analysis of this bill.

### PURPOSE OF THE BILL

The author's staff has indicated the purpose of the bill is to attract investment to the state by lowering state income taxes for companies with substantial investment in property and payroll in California relative to sales.

Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ X PENDING

Department Director

Date

Will Bush for Gerald H. Goldberg 5/14/04

## **EFFECTIVE/OPERATIVE DATE**

This bill is a tax levy. Thus, it would be effective immediately, and apply to taxable years beginning on or after January 1, 2004.

## **POSITION**

Pending.

## **SUMMARY OF SUGGESTED AMENDMENTS**

Amendments are needed to resolve the implementation and technical concerns discussed in this analysis. See "Implementation Considerations" and "Technical Considerations" below.

## **ANALYSIS**

### **FEDERAL/STATE LAW**

Under existing federal law, corporations organized in the U.S. are taxed on their worldwide income, regardless of source, and are allowed a credit for any taxes paid to a foreign country on their foreign source income. Foreign corporations engaged in a U.S. trade or business are taxed at regular U.S. graduated corporate income tax rates on income effectively connected with the conduct of that business in the U.S.

Under current California law, California source income for corporations that operate both within and without the state is determined on a worldwide basis using the unitary method of taxation. Under the unitary method, the business income of related affiliates that are members of a unitary business is combined to determine the total business income of the unitary group. A share of that income is then apportioned to California on the basis of relative levels of business activity in the state, as measured by property, payroll, and sales.

As an alternative to the worldwide basis, California law allows corporations to elect to determine their income on a "water's-edge" basis. Water's-edge electors generally can exclude unitary foreign affiliates from the combined report used to determine income derived from or attributable to California sources.

The general apportionment formula, applicable to most corporations, takes into account property, payroll, and double-weighted sales factors. Each factor is the ratio of in-state activity to that same activity worldwide. The taxpayer's apportionment percentage is determined by dividing the sum of the factors by four.

For corporations that derive more than 50% of their gross business receipts from agricultural, extractive, savings and loan, and banking and financial business activities, the apportionment formula is the average of three factors — property, payroll, and single-weighted sales.

Business income is multiplied by the apportionment percentage to determine the amount of income apportioned to this state for tax purposes.

THIS BILL

This bill would replace the three-factor, double-weighted sales apportionment formula used by certain corporations.

**For taxable years beginning on or after January 1, 2005 and before January 1, 2006**, this bill would require business income to be apportioned with a three-factor apportionment formula with single-weighted payroll and property factors and a sextuple-weighted sales factor, with a denominator of eight. This provision would only apply to corporations with a business described by the Internal Revenue Service (IRS) as "principal business activity codes" (PBAC): 311900, 325410, 333200, 334110, 334410, 511210, 512100, or 541519. Exceptions to this formula would be provided for three groups:

1. For each taxable year, taxpayers that file a combined report, that have a sales factor for the taxable year that is less than the average of their property and payroll factors and that **fail to meet** the two following requirements:

- the average number of employees the taxpayer has in this state during the taxable year is at least 90% of the average number of employees employed in California during any of the preceding five years; and
- the percentage change in the number of employees that taxpayer has in California between the current and preceding taxable year is less than or equal to the cumulative percentage change in all other states of the United States in which the taxpayer is engaged in business.

In other words, taxpayers that file a combined report and have an average of property and payroll in California in excess of sales would use the three-factor sextuple-weighted sales formula only if certain employment requirements are maintained. If all of the employment requirements are not maintained, the taxpayer must use the three-factor, double-weighted sales formula.

The bill also provides that the employees of a member of a combined group that is either acquired or disposed of during the taxable year are not counted for the prior taxable years in applying the two tests described above.

However, if the employment requirements were not maintained because of a natural disaster or other act of God, an act of terrorism, or an action of federal, state, or local government, the taxpayer would use the three-factor sextuple-weighted sales /single-factor sales formula.

In the instructions to Form 1120, 2003, the IRS published the following definitions of the above PBACs:

- 311900 Other Food Mfg (including coffee, tea, flavorings & seasonings)
- 325410 Pharmaceutical & Medicine Mfg
- 333200 Industrial Machinery Mfg
- 334110 Computer & Peripheral Equipment Mfg
- 334410 Semiconductor & Other Electronic Component Mfg
- 511210 Software Publishers
- 512100 Motion Picture & Video Industries (except video rental)
- 541519 Other Computer Related Services

The Form 1120 instructions further state that the taxpayer is to assign the PBAC for the activity from which the company derives the largest percentage of its total receipts.

2. Taxpayers that derive more than 50% of their gross business receipts from a business activity described in PBACs 211110, 324110, or 424700 would also be allowed to elect by contract either: the three-factor sextuple-weighted sales formula (or after 2005, the single sales factor formula), or the existing three-factor, double-weighted sales formula. The election must be made on an original return and is binding until the taxpayer elects to terminate the election with the Franchise Tax Board's consent or after the taxpayer is acquired by a non-electing entity or combined group that is larger than the taxpayer as measured by equity capital.

In the instructions to Form 1120, 2003, the IRS published the following definitions of the directly above PBACs:

- 211110 Oil & Gas Extraction
- 324110 Petroleum Refineries (including integrated)
- 424700 Petroleum & Petroleum Products

3. Taxpayers that derive more than 50% of their gross business receipts from banking, financial, or savings and loan activity would still be required to use a three-factor equally weighted apportionment formula. Banking and financial activity means dealings in money capital that is in competition with national banks. Savings and loan activity means any activities performed by a federal or state chartered savings and loan association or savings bank.

The bill defines "gross business receipts" as sales defined under the existing apportionment rules except that it also includes sales that may have been excluded under the apportionment rules by reason of a petition filed with or required by the Franchise Tax Board. "Apportioning trade or business" means a distinct trade or business whose income is required to be apportioned under the Corporation Tax Law (CTL).

The bill would provide that if any word, phrase, or other provision of the apportionment formula provisions is found unconstitutional or is otherwise unenforceable, the remaining provisions would remain in force and effect.

**For taxable years beginning on or after January 1, 2006**, this bill would replace the single-weighted payroll and property factors and a sextuple-weighted sales factor apportionment formula with a single factor apportionment formula based solely on sales.

#### IMPLEMENTATION CONSIDERATIONS

This bill would raise the following implementation concerns:

It is unclear how the PBAC applies to a taxpayer. It could be interpreted to apply to the whole of the worldwide unitary or water's edge group as if the group was a single legal entity or it could be applied by reference to the actual filing position for federal purposes. If applied on the federal filing, many foreign worldwide filers for California purposes do not file a federal return. In either case, the result may not be in what the author intended. Conceivably, a taxpayer could derive less than 1% of its total receipts from one of the PBACs listed and still be required to use the apportionment formula required by this bill.

The bill provides that taxpayers in certain extractive industries may elect to use one of three apportionment formulas. The bill further states the election is to be made by contract and implies the election is forever binding until other events take place. The term "contract" has a different meaning than "election." The author may desire to reword the language to remove the word "contract" and explicitly bind the election.

### TECHNICAL CONSIDERATIONS

On page 9, line 26, the word "business" needs to be inserted between the words "all" and "income." Otherwise, the subdivision would require certain taxpayers to apportion non-business income.

The PBACs occasionally change. Additionally, the IRS derives the PBACs from the North American Industry Classification System (NAICS). The author may desire to reference the NAICS, as of a specified date, to insure the targeted industries are later included.

On page 7, line 25-26, the bill references a water's edge election under Section 25111(b). Due to a 2003 law change, the proper reference should be Section 25113.

### **LEGISLATIVE HISTORY**

AB 2560 (Vargas, 2001/2002) contained the same provisions as in this bill. AB 2560 failed passage in the Assembly Revenue and Taxation Committee.

AB 1642 (Harman, 2001/2002) and SB 1014 (Johnson, 2001/2002) would have replaced the apportionment formula used by most corporations with a single-factor sales formula based. Certain extractive corporations would have been allowed to use a different formula. Both bills died because they failed to pass to the second house before the constitutional deadline.

### **PROGRAM BACKGROUND**

Prior to 1993, California law strictly conformed to the Uniform Division of Income for Tax Purposes Act, which provides for the use of an apportionment formula when assigning business income to a state for tax purposes. This formula is the simple average of three factors: property, payroll, and sales. Each factor is the ratio of in-state activity to that same activity everywhere.

In 1993, California law was amended to double-weight the sales factor. However, certain taxpayers engaged in extractive and agricultural businesses were adversely impacted and objected. To resolve this issue, those taxpayers that derive more than 50% of their gross business receipts from an extractive or agricultural business are provided an exception to the use of the double-weighted sales factor and are instead required to use a single-weighted sales factor in the apportionment formula.

In 1994, the exception to the use of the double-weighted sales factor was expanded to include taxpayers that derive more than 50% of their gross business receipts from savings and loan, banking, or financial business activities.

The requirement for double-weighting the sales factor reflects a determination that sales represent a more significant contribution to a taxpayer's net income than the other two factors. Incidentally, double-weighting the sales factor shifts some tax burdens to companies with large sales in California relative to their investment in property and payroll, and reduces the tax burdens of corporations that have made substantial investment in property and payroll in California relative to sales.

## OTHER STATES' INFORMATION

*Florida, Massachusetts, Michigan, Minnesota, and New York* all use an apportionment formula based on property, payroll, and sales. The sales factor is more heavily weighted than the other two factors for all of these states as indicated in the table below. *Illinois* uses an apportionment formula based entirely on sales. Some of these states provide special apportionment formulas for specific industries. *Massachusetts* uses an apportionment formula entirely based on sales for defense contractors, manufacturers, and mutual fund service corporations. The laws of these states were reviewed because of similarities to California's income tax laws.

	Property Factor	Payroll Factor	Sales Factor
California	25%	25%	50%
Florida	25%	25%	50%
Illinois	--	--	100%
Massachusetts	25%	25%	50%
Michigan	5%	5%	90%
Minnesota	12.5%	12.5%	75%
New York	25%	25%	50%

## FISCAL IMPACT

If the bill is amended to resolve the implementation considerations addressed in this analysis, the department's costs are expected to be minor.

## ECONOMIC IMPACT

### Revenue Estimate

The revenue impact of this bill is estimated to be as shown in the following table:

Estimated Revenue Impact of AB 2950 Assumed Enacted After June 30, 2004 Effective for tax years BOA Jan. 1, 2005 \$ Millions		
2004-05	2005-06	2006-07
-\$25	-\$150	-\$170

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion:

The revenue impact of this proposal would depend on the change in tax liabilities from the proposed apportionment formula as compared with current formula. Some corporations would pay more tax, others less.

Samples of corporate tax returns for the tax years 1999, 2000, and 2001 were used for this analysis. For each corporation, tax liabilities under current and the proposed apportionment formulas were computed. The revenue impact was estimated as the difference between the computed tax liabilities. The impact for each individual corporation was then statistically weighted and aggregated to derive an estimate of the total revenue impact for each of the above sampled tax years. It is projected that 90% of corporations with sales factors less than the averages of the other two factors would be required to use the single sales-factor formula. This projection is based on an analysis of the relationship between California wages from corporate sample data. The revenue impact of the proposal was computed as the average of the three estimates. The estimated impact is assumed to grow at the same growth rate as corporate profits for future years.

This bill would increase the tax liability of some taxpayers, and decrease the tax liability of others. The bill would decrease the tax liability of extractive corporations, and qualified corporations that have sales factors less than the averages of payroll and property factors and meet at least one of two employment tests. The bill would increase the tax liability of many agricultural corporations, and qualified corporations with sales factors greater than the averages of payroll and property factors (mostly non-California-based corporations). Since the tax decreases are estimated to be substantially more than the tax increases, the bill would result in ongoing tax revenue losses.

**LEGAL IMPACT**

There have been some concerns expressed in tax literature that a single-factor formula might be unconstitutional if done with the intent to benefit local commerce. In general, a single-factor sales formula would benefit companies that are physically located in one state to the detriment of those located outside that state. An equally weighted three-factor formula has been the bench mark to measure distortion, while a single-factor formula is more readily subject to distortions in the market and therefore more likely to be subject to litigation.

Further, requiring certain taxpayers that file a combined report to use the current three-factor, double-weighted sales formula, instead of the single-factor or heavily-weighted sales formula, could be subject to challenge since the requirement would not apply to apportioning taxpayers that are not members of a combined group.

The bill provides that if any word, phrase, or other provision is found to be unconstitutional, the remaining provisions of new Section 25128 still apply. CTL Section 23057 states that any provision of the CTL that is found unconstitutional "and can be reasonably separated" from the remaining portions of the law shall remain in effect. Because this bill does not contain the phrase "and can be reasonably separated," this bill's provision arguably means something different than Section 25057 that covers all of the CTL.

## **ARGUMENTS/POLICY CONCERNS**

Current law provides an exception to the use of the three-factor, double-weighted sales formula for corporations that derive more than 50% of their gross business receipts from agricultural or extractive activities. These corporations are instead required to use a three-factor, single-weighted sales formula because of the adverse impact on those industries by a formula that weighs sales more heavily than other factors. Of the activities that currently receive an exemption from the more heavily-weighted sales formula, this bill would provide an exception only for certain oil and gas related extractive activities.

## **LEGISLATIVE STAFF CONTACT**

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